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SHAREHOLDERS AND SOCIAL WELFARE

*William W. Bratton & Michael L. Wachter*

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# Shareholders and Social Welfare

*William W. Bratton*<sup>\*</sup> & *Michael L. Wachter*<sup>\*\*</sup>

## I. INTRODUCTION

Shareholder value maximization is widely equated with social welfare maximization. Those who make the association tend to go on to assert that management agency costs are excessive and that increased shareholder power would reduce the costs. Reduced agency costs by definition enhance shareholder value, which in turn is assumed to imply social welfare enhancement. Under this theory, shareholder wealth maximization, it seems, is a key that unlocks the door to making the world a better place. But a question arises: Who are these shareholders, and how does benefitting them result in benefits to everyone else?

This Article addresses the questions of whether and how shareholders matter for social welfare, finding that different and contrasting answers have prevailed during different periods of recent history. Observers in the mid-twentieth century believed that the socioeconomic characteristics of real-world shareholders were highly pertinent to social welfare inquiries. But those observers went on to conclude that there followed no justification for catering to shareholder interest, for shareholders occupied elite social strata. The answer changed during the twentieth century's closing decades, when observers came to accord the shareholder interest a key structural role in the enhancement of economic efficiency even as they also deemed irrelevant the characteristics of the human holders of shares. Under this view, the shareholder interest, as the residual claim on corporate wealth, is directly aligned with society's interest in maximizing corporate—and therefore societal—wealth, and so the shareholder interest qualifies for political solicitude. In recent years, the quest for political solicitude has made the jump from theory to practice: a “shareholder class” is said to have risen in our political economy as an

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offshoot of the growth of stock ownership among the middle class. Thus, real-world shareholders again are seen to bear on social welfare.

This Article takes a critical look at both of the prevailing claims regarding shareholders and social welfare. We make a technical correction of the claim regarding the maximization of corporate wealth: it is not, strictly speaking, a social welfare claim, but a narrower claim addressed to economic efficiency. We then enter an empirical objection to the political-economic extension: the shareholder class is not meaningfully middle class and retains elite characteristics.

Part II describes the mid-twentieth-century view of shareholders and social welfare. Under this view, shareholders are consumers who play no further productive role in the economy. Who they are matters accordingly: as a wealthy social subset, their interests count for little in the social welfare calculus.

Part III describes the late-twentieth-century view of shareholders and social welfare, the shareholder-primacy approach that dominates contemporary corporate legal theory. Shareholder primacy draws on welfare economics to effect a complete reversal. Shareholders now are seen on the producing rather than the consuming side of the economic coin, playing two structural roles. In the first role, shareholder interest in the maximization of the value of shares serves as the corporation's objective function. In the second role, their actions provide corporate managers with more particular instructions on the proper conduct of business. This happens (1) when shareholders vote on contested director elections and on issues such as executive compensation, and (2) when their purchases and sales of shares yield market prices that reflect their valuation decisions.

As a matter of economic theory, the shareholder-primacy construct holds out no claim regarding social welfare enhancement. Its focus on agency cost reduction looks toward a production optimum. Shareholder primacy thus should be cabined in the category of economic efficiency. Also, there are serious problems with real-world applications of the efficiency construct. On the one hand, shareholder votes and market prices do not necessarily provide sound instructions for corporate managers. On the other hand, some shareholders are relevant indeed. Substantial shareholders such as private equity firms, hedge funds, and corporate managers themselves play critical roles in business planning. What distinguishes and qualifies them is not their shareholding per se but their incentives and their informed view of the companies' policies—properties they do not share with the shareholders at the core of the theoretical vision of shareholder primacy.

Significantly, the shareholders' socioeconomic identities remain unimportant on both sides of this discussion. Shareholders perform the functions described in shareholder-primacy theory as cogs in a value-creating machine. As the analysis implicates no social welfare calculations, shareholder socioeconomic profiles do not come to bear.

Social welfare comes back to the fore in Part IV, which examines the political-economic extension of shareholder-primacy theory. This describes a shareholder class that appropriately wields influence in the realm of public policymaking. The description focuses on the diffusion of shareholding downward from the socioeconomic elite into the middle and working classes. Downward shareholder diffusion resulted from pension fund saving schemes and the appearance of cheap, diversified equity-investment vehicles. The public dominates the private in the resulting picture of corporate politics—shareholders emerge as a democratic interest group engaged in a struggle with an entrenched hierarchy. The description is correct in one respect: the shareholder interest has achieved political salience. But the depth of the change in the shareholders' socioeconomic profile is subject to question.

Part V follows other scholarship<sup>1</sup> in testing the shareholder class description against the data. The test draws on the Federal Reserve Board's Survey of Consumer Finances and data from the Internal Revenue Service to show that even as shareholding has diffused downward to lower income individuals, the shareholders' overall socioeconomic status has remained largely unchanged. The modal shareholder in the data is rich, old, and white. It follows that there is nothing inherently democratic or progressive about the shareholder interest in corporate politics. Indeed, shareholder politics is better described as a contest between two elite groups: corporate managers and investment intermediaries, which act as delegates of the same elite class of shareholder beneficiaries.

Our objective is to describe accurately and thereby clear noise from the screen. Descriptive accuracy matters because corporate governance and shareholder primacy have stepped out of their original economic confines into the political economy. Shareholders are now political combatants, and combatants' societal positions matter in political characterizations. Given the shareholders' elite societal position, framing corporate politics as a democratic uprising against oligarchic hierarchs is quite simply inaccurate. Claims of social welfare enhancement are similarly dubious. This descriptive detritus having been cleared away, corporate

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1. See Paddy Ireland, *Shareholder Primacy and the Distribution of Wealth*, 68 MOD. L. REV. 49 (2005); James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption*, BROOKINGS PAPERS ON ECON. ACTIVITY, Oct. 1995, at 295.

governance can be properly placed in the political-economic picture as the real-world manifestation of an economic-efficiency analysis.

## II. POSTWAR MANAGERIALISM: THE RICH, STRUCTURALLY IRRELEVANT SHAREHOLDER

Today, we tend to think of the separation of ownership and control as a problem that needs to be solved. But that has not always been the case. During the two decades after World War II, many viewed the separation of ownership and control as the platform for a new and beneficial form of capitalism. Under this view, management control led to productive outcomes. So long as the managers remained subject to appropriate government oversight, social welfare would be enhanced. Shareholders had no place in this picture of management productivity and welfare enhancement. They were mere consumers, and as rich consumers, had no claim to solicitude when planners articulated the social welfare function.

### *A. The Ascendancy of Managerial Capitalism*

The postwar era was a time of management ascendancy. Corporate managers had emerged as empowered actors in the economy and in society. And as had not been the case during the Depression era, management's productive success was there for all to see.

Theory followed practice. It was thought that Schumpeter's description of creative destruction in the introduction of new products and processes provided a more accurate picture of capitalism than static equilibrium analysis in the tradition of Adam Smith and Alfred Marshall.<sup>2</sup> More particularly, corporate managers now operated outside of the invisible hand of classical economics<sup>3</sup> so that wealth creation no longer stemmed from the efforts of atomistic strivers in markets for products and labor. Instead, the economy's dynamic forward motion originated in discretionary decisions made by skilled technocrats in the management suites of large corporations.<sup>4</sup>

Just as it is now, the question then was whether management power was adequately contained. Many thought that it was, on the theory that a variety of constraints worked in tandem.<sup>5</sup> Product markets still imposed competitive constraints.<sup>6</sup> Organized groups like labor and trade associa-

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2. Edward S. Mason, *The Apologetics of "Managerialism,"* 31 J. BUS. 1, 8 (1958).

3. *Id.* at 3, 10.

4. *Id.* at 1.

5. *Id.*

6. *Id.* at 2.

tions exerted countervailing power.<sup>7</sup> Managers themselves pointed to internal constraints—they were evolving as a class toward responsible professionalism.<sup>8</sup> Finally, a big-stick state kept watch on the sidelines.

Adolf Berle, whose voice sounded loudly in the chorus of approval, worked the various strands into a political economy of the large corporation. Corporate managers worked cooperatively with a strong regulatory state toward the end of social welfare enhancement. For Berle, the state could and did accurately articulate the social welfare function and then guide and push markets to correct results.<sup>9</sup> But it was not socialism. The old economic order of private property persisted<sup>10</sup> and did the producing, incentivized by the profit motive.<sup>11</sup> The state intervened only to stabilize its organizational lines and performance.<sup>12</sup> The United States had avoided more extensive state intervention in economic institutions, but only because sophisticated private actors, such as corporate managers, had learned to moderate their conduct and to work in a regulated environment. They had seen that the state's regulatory power took precedence over their own economic power and accordingly had restrained the exercise of their power for the sake of its own preservation.<sup>13</sup>

Corporate managers emerged as quasi-public servants in this framework. The power stemming from the concentration of productive functions in the hands of a few provided the means to realize a planned economy in which the interests of the community as a whole came to bear on economic decisions.<sup>14</sup> The legitimacy problems stemming from corporate power were solved by an equipoise among strong organizations and economic forces: the need to profit;<sup>15</sup> the residuum of competition within oligopolies; the labor unions; and, given the misuse of power or a crisis, the state.<sup>16</sup> Public opinion—the consensus—lay behind all of these, operating slowly but, in the long run, determinatively.<sup>17</sup> It also bore on managers directly. Similar to politicians, managers who violated

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7. See generally JOHN KENNETH GALBRAITH, *AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER* (1952).

8. RUSSELL W. DAVENPORT, *U.S.A.: THE PERMANENT REVOLUTION* 68, 79 (1951).

9. ADOLF A. BERLE, *THE AMERICAN ECONOMIC REPUBLIC* 95, 99, 169 (1963) [hereinafter BERLE, *REPUBLIC*].

10. *Id.* at 99.

11. ADOLF A. BERLE, JR., *POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY* 94 (1959) [hereinafter BERLE, *POWER*].

12. BERLE, *REPUBLIC*, *supra* note 9, at 99.

13. *Id.* at 169.

14. ADOLF A. BERLE, JR., *THE 20TH CENTURY CAPITALIST REVOLUTION* 32, 34–35 (1954) [hereinafter BERLE, *20TH CENTURY*].

15. BERLE, *POWER*, *supra* note 11, at 90.

16. *Id.* at 89–92; BERLE, *20TH CENTURY*, *supra* note 14, at 53–59.

17. BERLE, *20TH CENTURY*, *supra* note 14, at 53–57.

community values lost prestige and esteem, a loss that could in turn undermine their place in the organization.<sup>18</sup> The corporation thus did have a conscience, one imposed by the community outside.<sup>19</sup>

The corporate manager became a “non statist civil servant,”<sup>20</sup> a nonstate actor nonetheless subject to the consent of the governed.<sup>21</sup> Social responsibilities followed. As a wielder of power in the interdependent system, a manager would be held to responsibilities to suppliers, customers, employees, and shareholders, along with other more peripheral constituents. This was an unenviable position. A manager could be caught by surprise between the emergent public consensus and the responsive state, grappling in the unfamiliar territory of political accountability.<sup>22</sup> The best defense was a satisfied American public. Happily the U.S. public, unlike that in other countries, imposed no unreasonable demands.<sup>23</sup> So corporate leaders could manage their political positions by honestly stating what they could and could not deliver given their constraints.<sup>24</sup>

### *B. The Irrelevant Shareholder*

Berle is remembered for posing the shareholders as a necessary countervailing power to managers in a 1932 debate with E. Merrick Dodd.<sup>25</sup> Berle maintained that position only briefly. Indeed, he and Gardiner Means suggested a contrasting role for shareholders the same year in the final chapter of their famous book, *The Modern Corporation and Private Property*.<sup>26</sup> Given separated ownership and control, explained Berle and Means, shareholders emerged as passive collectors of dividends with no productive role to play in the political economy. Because the shareholders had given up responsibility for corporate property, other constituents should join them as corporate beneficiaries. The “rigid enforcement of property rights” of passive shareholders would give way in the face of a “convincing system of community obligations.”<sup>27</sup>

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18. BERLE, POWER, *supra* note 11, at 90.

19. *Id.*

20. *Id.* at 8.

21. BERLE, 20TH CENTURY, *supra* note 14, at 59–60.

22. BERLE, POWER, *supra* note 11, at 8.

23. BERLE, 20TH CENTURY, *supra* note 14, at 59.

24. *Id.*

25. The back and forth began with Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931). Dodd responded in E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). Berle then rebutted in Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

26. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Macmillan 1933) (1932).

27. *Id.* at 356.



Berle expanded on this theme in his later writing.<sup>28</sup> Not only were shareholders irrelevant, so were the capital markets on which shares were sold and traded. The capital-allocation function had passed from the securities markets to the internal capital market. Berle pointed out in 1954 that during the preceding six years 64% of invested capital had been financed by retained earnings and only 6% from new equity.<sup>29</sup> It followed that the stock exchanges no longer served primarily as places for new investment and capital allocation—traditional functions only implicated in the rare instance of a new issue of common stock. The markets instead served as mechanisms for investor liquidity, a service provided for the benefit of the original owners' passive grandchildren or the transferees of their transferees. Any connection to capital gathering and productive allocation was for the most part psychological.<sup>30</sup>

The shareholders dropped out of the governance picture. Federal bureaucrats wielding the securities laws now patrolled the markets.<sup>31</sup> The annual election of directors played a minimal legitimating role in the wider political framework—a ritualized community process pursuant to a hoary legal template.<sup>32</sup> Proxy fights, which had taken the stage in the 1950s, did not imply renewed empowerment for equity capital.<sup>33</sup> Although always a possibility, control upsets by proxy were rare and tended to involve smaller firms.<sup>34</sup> With bigger firms, the vote was getting ever more dispersed, further diminishing its importance and embedding passivity.<sup>35</sup> As a practical matter, managers operated in “tiny, self-perpetuating oligarchies,” drawn from and evaluated by the business and financial community,<sup>36</sup> itself an elite group.

All of this caused Berle to pose fundamental questions about shareholders:

Why have stockholders? What contribution do they make, entitling them to heirship of half the profits of the industrial system . . . ? Stockholders toil not, neither do they spin, to earn that reward. They

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28. See, e.g., BERLE, 20TH CENTURY, *supra* note 14; BERLE, POWER, *supra* note 11; Adolf Berle, Jr., *Property, Production and Revolution: A Preface to the Revised Edition* of ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Harcourt, Brace, & World, Inc. rev. ed. 1968) [hereinafter Berle, *Preface*].

29. BERLE, 20TH CENTURY, *supra* note 14, at 36–37 (acknowledging exceptions for utilities and new industries); see also BERLE, POWER, *supra* note 11, at 45 (noting that 10% to 15% of new capital came from pension funds and insurance companies and 20% from bank borrowing).

30. Berle, *Preface*, *supra* note 28, at xxvii, xxxiii–iv.

31. *Id.* at xxxiii.

32. BERLE, POWER, *supra* note 11, at 104–05.

33. BERLE, REPUBLIC, *supra* note 9, at 63.

34. *Id.*

35. Berle, *Preface*, *supra* note 28, at xxxi.

36. BERLE, 20TH CENTURY, *supra* note 14, at 180.

are beneficiaries by position only. Justification for their inheritance must be sought outside of classic economic reasoning.<sup>37</sup>

Only one role remained for them. As passive property holders who wielded no power, they still might be socially justified for their distributive role in the polity.<sup>38</sup> Indeed, shareholders used their wealth to provide for their families, pay their taxes, and support charitable institutions.<sup>39</sup> But there was a catch: *full* justification for the shareholder interest would follow only when shareholder wealth became so widely distributed as to benefit every American family.<sup>40</sup> Only once society's distributional concerns were met could the shareholder interest serve as a proxy for societal interest and thus hold out political-economic salience.

Others saw things similarly. If shareholdings were not widely distributed across the population, maybe returns to large-company shareholders should be limited to fixed interest plus a small-risk premium.<sup>41</sup> Alternatively, the tax system should target redistribution of shareholder returns.<sup>42</sup>

### C. Summary

In the postwar era, managers were seen as well-incentivized, technocratic oligarchs, and the function of monitoring managers was seen as best vested in public authorities and public opinion. Shareholders had no role to play in the creation of wealth. They were placed on the receiving end as consumers and savers. As such, they had no valid claim on the attention of a benevolent sovereign occupied with maximizing social welfare, for they were already wealthy and their needs well satisfied.

### III. LATE-TWENTIETH-CENTURY CORPORATE LEGAL THEORY: SHAREHOLDER VALUE AS ECONOMIC EFFICIENCY

The managerialist approach made sense only so long as managers delivered the goods and services. Views on that subject changed in the 1970s in the face of stagflation, a failing stock market, and a perception of national competitive decline in global markets. Together these problematized the productive and financial performance of corporate managers. The theory of the firm simultaneously turned back to its premanagerialist starting point in classical economics, redirected by Mi-

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37. BERLE, REPUBLIC, *supra* note 9, at 51–52.

38. See Berle, *Preface*, *supra* note 28.

39. BERLE, REPUBLIC, *supra* note 9, at 51–52.

40. Berle, *Preface*, *supra* note 28, at xxxv; see also Adolf A. Berle, *The Impact of the Corporation on Classical Economic Theory*, 79 Q. J. ECON. 25, 39 (1965).

41. See Mason, *supra* note 2.

42. *Id.* at 4 (reporting on the thinking of the British Labour Party and making an extension).

chael Jensen and William Meckling's paper, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*.<sup>43</sup>

Jensen and Meckling introduced a new line of microeconomic theory that succeeded where classical microeconomics stopped short. Their theory modeled the governance of large firms with separate ownership and control as incidents of contracting among rational economic actors.<sup>44</sup> Optimal economic results in competitive markets returned as the corporate objective function. Here was the new question: What was the best way to incentivize managers to maximize wealth? The answer was to direct them to the shareholders because shareholders alone had the incentive to maximize corporate wealth as the residual claimants.<sup>45</sup>

The proposition that the shareholder value objective maximizes wealth operates at two levels. The first level, described in section A, states the proposition in a minimal form. Wealth is maximized when markets are competitive and producing actors see their role as value maximizers. The shareholder emerges as the systemic focal point because their incentives are most compatible with value maximization. For simplicity, agency costs are assumed away at this stage. Section B takes up shareholder value maximization and wealth maximization at a second level. The no-agency-cost assumption is relaxed. This transforms the governance instruction (managing for the shareholders' benefit) into a governance problem (reducing agency costs). Shareholder advocates address the problem with a law reform agenda to empower shareholders. At this point real-world shareholders become relevant, but not so far as concerns their personal wealth or place in society. There are two premises: first, that agency costs are out of control; and second, that opening a door for determinative shareholder inputs will contain agency costs. The inputs, in turn, are shareholder voting and market-pricing activities. Section B tests these premises against the activities of real-world shareholders as they trade shares and intervene in corporate governance. The tests ultimately undercut both premises.

From the point of view of economic theory, "social welfare" does not necessarily enter into this discussion, which concerns only the creation of wealth. Social welfare concerns wealth distribution and need not be considered until the efficient corporate pie has been placed on the ta-

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43. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); see also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

44. William W. Bratton, Jr., *The Nexus of Contracts Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 417 (1989).

45. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 665–68 (2010).

ble. Even so, proponents often speak of shareholder value maximization as social welfare maximization. The usage is inappropriate.

### A. *The Corporate Objective Function*

This section describes the economic logic that puts shareholder value maximization in place as the corporation's objective function. The exercise directly extends the first fundamental theorem of welfare economics. Strictly speaking, it provides a basis for describing shareholder value maximization as wealth maximization, but not as social welfare maximization. If one puts the theory aside for a moment, a related question can be asked: whether shareholder value maximization legitimately can be characterized as a "proxy" for social welfare maximization. The answer to the question is highly contestable. But it is better, when speaking theoretically, not to put the theory to one side in the first place. Accordingly, shareholder value should not be deemed a proxy for social welfare. In any event, the socioeconomic attributes of real-world shareholders have no bearing on the wealth-maximization discussion.

### 1. Welfare Economics

The first fundamental theorem of welfare economics follows from a general equilibrium model of the economy. All individuals and firms are price takers, each firm produces so as to maximize its profits subject to a production constraint, and each individual consumes so as to maximize individual utility.<sup>46</sup> Externalities are assumed away.<sup>47</sup> The theorem poses that a competitive equilibrium is good for the economy because it maximizes wealth.<sup>48</sup> The normative implication is that what can be done to make the economy competitive should be done. If improvements can be made to the functioning of the markets, the improvements should be made—information asymmetries should be remedied and barriers to competition should be removed.<sup>49</sup> Doing so moves the economy to a production-possibility frontier—the set of Pareto optimal points at which there can be no more of *A* without having less of *B*. For a given producer,

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46. See Allan M. Feldman, *Welfare Economics*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS 722 (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008).

47. *Id.* at 723.

48. *Id.*

49. Thus do neoclassical economists address themselves to identifying and correcting flaws that keep the economy away from the efficient frontier—economics seeks to create market mechanisms, fill in missing markets, and otherwise identify and correct market failures. See Gillian K. Hadfield, *Feminism, Fairness, and Welfare: An Invitation to Feminist Law and Economics*, 1 ANN. REV. L. & SOC. SCI. 285, 289 (2005).

a situation is Pareto optimal if no alternative corporate policy would result in the production of more output (or a need for less of some input).<sup>50</sup>

The first fundamental theorem makes no further assertions concerning the distribution of the wealth thus created.<sup>51</sup> It looks only to economic efficiency—the creation of aggregate wealth. The proposition of the second fundamental theorem of welfare economics concerns social welfare. The proposition poses a heroic optimum: once the economy has reached the production-possibility frontier, optimal social welfare can be achieved through appropriate lump-sum taxes and transfers.<sup>52</sup> There's a catch, however, because a tax-and-transfer regime that impairs productive incentives is suboptimal and arguably “inappropriate.”<sup>53</sup> Optimal results are unattainable; accordingly, the best we are going to get is second best. The theory of the second best comes to bear at this point. This theory poses that a costly tax-and-transfer regime can conceivably enhance social welfare utility in the context of an economy producing below the production-possibility frontier and so be deemed the preferable outcome.<sup>54</sup>

## 2. The Corporate Extension

The first theorem can be restated for a given system of corporate governance. Marco Becht, Patrick Bolton, and Ailsa Röell articulate the restatement as follows: a system is “ex ante efficient if it generates the highest possible joint payoff for all the parties involved, shareholders, creditors, employees, clients, tax authorities, and other third parties that may be affected by the corporation’s actions.”<sup>55</sup> The extension, which embraces all corporate constituents, is uncontroversial and generally accepted in corporate legal theory.<sup>56</sup> Shareholder value maximization follows from further analysis.

50. Feldman, *supra* note 46, at 722–23.

51. *Id.* at 723.

52. More particularly, given the outcome of the first theorem, almost any Pareto optimal equilibrium can be achieved given imposition of appropriate taxes and transfers. *Id.* at 724.

53. The same point can be restated so that economic equality is achieved: if one manipulates the *initial* allocation of goods and income with lump sum transfers, then the *ex post* workings of perfect markets can lead to an equal allocation of wealth. Hadfield, *supra* note 49, at 289.

54. See Richard G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 *REV. ECON. STUD.* 11 (1956).

55. Marco Becht et al., *Corporate Governance and Control* 15 (Nat’l Bureau of Econ. Research, Working Paper No. 9371, 2002), available at <http://www.nber.org/papers/w9371.pdf>. The text states one of two parts. The second part incorporates the preferences of the affected parties and holds that a system is Pareto optimal if no alternative system exists that all parties prefer. *Id.*

56. See, e.g., Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 *J. CORP. L.* 637 (2006); Ronald J. Gilson & Reinier Kraakman, *Clark’s Treatise on Corporate Law: Filling Manning’s Empty Towers*, 31 *J. CORP. L.* 599, 602 (2006).

Jensen and Meckling took the first step in this analysis. They posited that if we model the firm as a nexus of complete contracts among all parties involved while modeling the contract between a firm and its shareholders as incomplete (in that the shareholders claim the residual return after all other contractual claims have been met), then maximization of shareholder value is tantamount to the economically efficient result.<sup>57</sup> Note that the extension depends entirely on the model of constituent contracts: if all contracts other than the shareholders' are indeed complete and embody a maximizing trade for each party, then maximizing the shareholders' residual return does maximize value for all concerned. The robustness question accordingly devolves on the constituent-contracting assumption.

Shareholder value proponents make a two-part case in favor of the assumption's robustness. The first part is a claim for shareholder entitlement in a world of incomplete contracts. In fact, no one argues that in the real world all other stakeholders enter into complete contracts. But it is argued that, relatively speaking, the shareholders' contract holds out less in the way of protection than do the other constituents' contracts.<sup>58</sup> For example, employees can look to alternative employment at their opportunity wage in competitive labor markets, and creditors can take security or shorten their maturities. In contrast, the shareholders' capital is locked in for an indefinite duration with their only further protection stemming from governance arrangements. The diagnosis of relative vulnerability leads directly to a claim of primacy in the statement of the corporate objective function.<sup>59</sup>

The second part of the case references alternatives to a shareholder maximand and finds them wanting. The argument proceeds in two phases. It is first asserted that decisionmaking costs should be minimized.<sup>60</sup> This in turn implies a limitation on the number of corporate constituents referenced in the objective function.<sup>61</sup> Multi-constituent models invite incoherence due to conflict among the interests referenced.<sup>62</sup> Incoherence in turn expands the scope of management discretion, potentially increasing management agency costs.<sup>63</sup> Second, the shareholders are the best

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57. See Becht et al., *supra* note 55, at 15–16. Agency costs are assumed away. *Id.*

58. See Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984).

59. See *id.*

60. See Becht et al., *supra* note 55, at 16.

61. See *id.*

62. See Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 9, 13 (2001).

63. The problem with multi-constituent models was the primary point made by Berle in attacking Dodd's introduction of the public interest as a separate concern. The irony of Berle's position was that Berle himself shortly thereafter introduced his own multi-constituent model suffering from

reference point among the available constituents. As they hold the residual claim, managing in their interest maximizes returns for the corporation as a whole.<sup>64</sup> Their capital investment<sup>65</sup> in the residual lends them an undiluted, pure financial incentive to maximize the firm's value.<sup>66</sup> From an incentive point of view, shareholders contrast favorably against managers and independent directors, whose incentives are compromised by interests in compensation and job retention.<sup>67</sup> The shareholders also contrast favorably against other constituents, whose contractual interests exclude the residual upside.

The theoretical tie to economic efficiency remains strong throughout the foregoing exercise. But it should be noted that any number of real-world complications can weaken the link. Recall that the first theorem assumes competitive behavior and assumes no externalities. Either a lack of competition among producers or unremedied externalization of costs by real-world producers undercuts the assumptions. Nor can the relative completeness of other stakeholder contracts be deemed irrelevant. Given incompleteness and conflicts of interest among different constituent groups, management decisions under a shareholder-maximization instruction can be value reductive. For example, shareholder centrism could lead to suboptimal decisions respecting labor relations or actions against creditor interests that trigger an overall increase in the cost of capital.

The caveats having been entered, we come to the recurring question: do the identities of given shareholders have any bearing on this maximization inquiry? The answer is no. Welfare economics does put the shareholder interest at the center of its picture of an efficient governance structure. But the shareholder whose interest is being maximized need not, and arguably should not, take on flesh and blood attributes. Individual identities are irrelevant here. Two more particular attributes should suffice to fill out the set of instructions to managers: (1) the shareholder should be assumed to be a value maximizer;<sup>68</sup> and (2) the shareholder should be fully diversified and, accordingly, bear only sys-

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the identical problem. See William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 J. CORP. L. 99, 111 (2008).

64. See, e.g., Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 449 (2001).

65. Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 138 (2001).

66. Hansmann & Kraakman, *supra* note 64, at 449.

67. Bratton & Wachter, *supra* note 45, at 666.

68. An interesting question arises about duration: should the shareholder be modeled as a *long-term* value maximizer? Many would say yes. It is our sense that shareholder-primacy theory elides the question, relying on the market price to merge the long term with the short term.

tematic market risk.<sup>69</sup> Even as the business cycle may work havoc with the shareholders' wealth, full diversification means that it is only economy-wide risk and not company-specific risk that matters.

The specifications having been made, it matters not at all whether actual shareholders are citizens in top wealth brackets or, for that matter, foreign aristocrats who use their corporate wealth to oppress third-world underclasses. We saw at square one that welfare economics remits these distributional concerns to later adjustment through taxation and transfer.

Now to the central question: can shareholder value maximization be characterized as social welfare maximization? As a matter of economic theory, the plain answer is no. But there is a follow up question: can shareholder wealth maximization appropriately be deemed a proxy for social welfare maximization? The two are often thus connected in the legal literature,<sup>70</sup> a connection that is just as often contested.<sup>71</sup> The association is unfortunate. To equate shareholder value maximization with social welfare maximization is to take an economic-efficiency analysis out of its appropriate theoretical confines and pretermite discussion of important follow-up questions. In our view, the follow-up discussion is best characterized as one of political economy.<sup>72</sup>

### *B. Agency Costs and Shareholder Empowerment*

We have seen that the shareholder in the shareholder maximand is an objective held out to managers—a component in a model of an incentive-compatible structure of corporate governance. We will now take the shareholder maximand a further step down the road from theory to prac-

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69. This follows from modern portfolio theory. See, e.g., Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 35 (2005) (asserting that only diversified outside shareholders have firm value maximization as their sole objective).

70. The base citation is Hansmann & Kraakman, *supra* note 64, at 441–42. The association runs deep. Empirical studies tend to equate share value maximization with social welfare. See, e.g., Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss Off*, 108 COLUM. L. REV. 749, 759 (2008). For criticism of the practice, see Fisch, *supra* note 56, at 640–46. Some observers approach the connection of the two with commendable caution. See Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 125 & n.2 (1994) (stating that social welfare maximization is “not necessarily inconsistent with shareholder wealth maximization”); see also Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139, 145–46 (2003) (explaining the meaning of proxy status).

71. See, e.g., Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334, 342–44 (2008) (asserting that the shareholder-primacy theory (1) depends on an unduly narrow conception of welfare, privileging narrow financial wealth instead of referencing preferences more broadly; (2) ignores distributive concerns; and (3) ignores general equilibrium effects on actors outside of the corporation).

72. Parts III and IV of this Article will show that the political economics of shareholding implicates the socioeconomic characteristics of real-world shareholders.



tice and relax the assumption that managers adhere to it slavishly. Agency costs enter into the picture, rising to the extent that managers fail to manage to the shareholder value objective.

### 1. The Case for Shareholder Empowerment

Shareholder proponents address agency costs with two claims: first “ultimate control” of the corporation should rest with the shareholders, and second, the market price of the stock should provide “the principal measure” of the shareholder interest.<sup>73</sup> The two claims, taken together, attempt to pull off a neat trick. On the one hand, shareholders should be accorded more power in corporate governance. On the other hand, their identities remain irrelevant, for their power should be exercised through a faceless trading market rather than in a face-to-face political arena.

The more particular case goes as follows. All other things equal, agency-cost reduction enhances value, and enhanced principal control conceivably can lower agency costs.<sup>74</sup> The shareholders, as principals, are well suited to provide value-enhancing inputs, for as we have seen,<sup>75</sup> their investment<sup>76</sup> in the residual interest lends them a pure financial incentive to maximize the company’s value.<sup>77</sup>

The question then becomes whether these pure shareholder incentives can be harnessed by the governance system despite the fact that dispersed, diversified shareholders labor under information asymmetries and lack business expertise. Here the market price of the stock comes in as the means to the end. If the stock price holds out an objective and accurate measure of the purely motivated shareholder maximand, then it provides the best source of instructions for governance and business policy. After all, it is in the financial market where shareholders, using the Holmstrom and Kaplan metaphor, “put their money where their mouths are.”<sup>78</sup> From this it follows that a manager-agent with correct incentives should manage to maximize the market price.<sup>79</sup>

73. Hansmann & Kraakman, *supra* note 64, at 440–41.

74. See COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT (2006), *available at* [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf) (asserting that shareholder rights serve the “critical function of reducing agency costs,” and that inadequate shareholder rights cause shares to trade at a discount to fundamental value).

75. See *supra* note 53 and accompanying text.

76. Holmstrom & Kaplan, *supra* note 65, at 138.

77. Hansmann & Kraakman, *supra* note 64, at 449.

78. Holmstrom & Kaplan, *supra* note 65, at 138 (noting that the price follows from actors putting their money where their mouths are); see also George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOU. L. REV. 1213, 1225 (2008) (“[N]o measure is better.”).

79. For a colorful exposition of this point of view, see Gilson & Kraakman, *supra* note 56, at 605, which depicts the shareholders as holding managers on a leash (in the manner of a pet dog). The

Thus do shareholder proponents contemplate a species of market control.<sup>80</sup> They want the market price to be the ongoing and determining source of shareholder input: managers who are effective agents should manage focused on the stock market in formulating business policy so as to access the high-quality instructions embedded in stock market prices. With the market price as the management yardstick, value-enhancing opportunities to merge, sell, or dissolve will no longer be frustrated by the managers' desire to hold on to control, resources will no longer be squandered on excessive executive pay, and governance arrangements will import appropriate constraints and incentives.<sup>81</sup> Managing to the market price is also thought to import administrative coherence because the yardstick provides a means with which to evaluate management performance.<sup>82</sup>

Value maximization pursued with a long-term time horizon is said to follow.<sup>83</sup> Here the proponents refer to basic principles of valuation, which teach that long-term value is impounded in the present market price.<sup>84</sup> It follows that managing to the market price is incentive compatible as far as concerns the time horizon because both short-term and long-term investors have incentives to maximize long-term value.<sup>85</sup>

Shareholder proponents do not deny that the market price is set under conditions of information asymmetry, and thus the market price is not fully informed.<sup>86</sup> The implied assertion is that any resulting divergences between the market price and fundamental value will not hold out perverse effects when even management focuses on an underinformed market price. An ameliorating factor has also been noted: some studies show that market prices became better informed across the past half-

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issue goes to the length of the leash. The more quickly the markets change, the shorter the leash. *Id.* Thus do the shareholders merge into the markets.

80. See COMM. ON CAPITAL MKTS. REGULATION, *supra* note 74, at 16 (asserting that strengthened shareholder rights go hand in hand with reduced regulation and litigation).

81. Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 840, 850 (2005).

82. Holmstrom & Kaplan, *supra* note 65, at 139.

83. Hansmann & Kraakman, *supra* note 64, at 451.

84. Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 522 (2002).

85. In the view of shareholder proponents, accountability suffers under the prevailing regime, leading to inefficient regulatory responses, including shareholder litigation. See COMM. ON CAPITAL MKTS. REGULATION, *supra* note 74, at 16, 96. Therefore, systemic reform to facilitate shareholder intervention is appropriate because the inherited model affords management discretionary space to disregard the price directive.

86. Finance theory often assumes that the market share price is always the correct measure of the fundamental value of the corporation. But it is understood that this is an assumption rather than a fact that can be validated by empirical tests.

century.<sup>87</sup> The information gap between the inside and outside of the corporation has narrowed, partly due to stricter mandatory disclosure requirements and partly due to thicker markets and a larger sector of information intermediaries.<sup>88</sup>

## 2. Rebuttal

We elsewhere rebut this shareholder case.<sup>89</sup> We summarize our points here because they have the effect of bringing real-world shareholders back into the governance picture. Our case has two phases: first, we question the quality of market-price signals; second, we question the diagnosis of persistent and excessive agency costs.

### *a. Perverse Effects Are Created by Managing to the Market*

The shareholder proponents pose a win-win situation: empowering shareholders lowers agency costs and makes everyone better off. They hold out the benefit without asking about unintended costs. We counter on the cost side.<sup>90</sup>

The agency-cost problem arises because managers use their superior information for their own advantage. The proponents want to address the costs by giving the shareholders sufficient power to impress their business policy preferences, as manifested in market-price signals. So the question is: what policy content does the market price have to teach? We offer a four-part answer.

First, if markets were strong-form efficient, reflecting all public and private information, the shareholder proponents would have a pretty good case. But the efficient capital market hypothesis does not predict that the market price is a true measure of fundamental value. Rather, it makes a more modest prediction that prices will follow a random walk and that no trading strategy based on public information can systematically outperform the market.<sup>91</sup> Its implications for corporate governance are accordingly modest.<sup>92</sup>

Second, the case for shareholder empowerment is stronger or weaker depending on the information on the public table and the governance issue. With hostile takeovers, the case is quite strong, because takeovers

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87. The empirical literature, which focuses on an increase in idiosyncratic volatility, is described *infra* notes 45–65.

88. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN L. REV. 1465, 1548–63 (2007).

89. Bratton & Wachter, *supra* note 45.

90. *Id.* at 688–715.

91. Burton G. Malkiel, *Efficient Market Hypothesis*, in THE NEW PALGRAVE DICTIONARY OF MONEY AND FINANCE 739, 739 (Peter Newman et al. eds., 1992).

92. Bratton & Wachter, *supra* note 45, at 691–94.

pose a relatively simple governance question in an information-enriched environment. But as you move away from an offer on the table to buy the company—a one-shot call one way or the other—to continuous business decisionmaking over time, the meaning of a market-price signal becomes less and less clear and information asymmetries present more of a problem. Prices are less objective reports on particular value outcomes than they are inputs for informed interpretation.<sup>93</sup>

Third, information asymmetries are real, and they are not going to go away. Complete disclosure is not cost-beneficial, period.<sup>94</sup> Degrees of information asymmetry vary from company to company and from time to time. A variety of economic literature confirms that business decisions become skewed as managers seek to take advantage of overvalued stock or sacrifice good projects for fear of undervaluation.<sup>95</sup>

Fourth, market prices are subject to speculative distortion. We look at the heterogeneous expectations models that came out of the academic woods in the wake of the technology stock bubble of the late 1990s.<sup>96</sup> These models posit that rational shareholders can bid up a stock above what they see as its fundamental value to take advantage of an option to sell it to buyers applying a more optimistic valuation.<sup>97</sup> We take some leading models and inquire into their implications for the legal model of the corporation.<sup>98</sup> Two points emerge. First, a duty to maximize the stock price can lead to decisions that sacrifice long-term value. Second, if you want to incentivize managers to maximize long-term value, you need to lock them into their shareholdings for the long term, that is, to incentivize them differently than the garden-variety market shareholder.

### *b. The Decreasing Salience of Management Agency Costs*

In our view, shareholder proponents have lost touch with their own paradigmatic roots. They pose an agency-cost win-win situation—empower the shareholders and reduce the costs—with no acknowledgment that doing so might trigger countervailing costs. Their cost picture dates from the 1980s takeover era, and it is posed as a static constant. Such a picture is the exact opposite of what Jensen and Meckling described in their fundamental exposition. First, they predicted that actors will address costs as they arise over time, with managers bonding their

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93. *Id.* at 694–96.

94. *Id.* at 696–98.

95. *Id.* at 698–703.

96. *Id.* at 706–08.

97. For the original model, see Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151, 1151 (1977).

98. Malkiel, *supra* note 91, at 709–16.

fidelity to their investors and investors monitoring their investments. Second, they predicted that when agency costs remain unaddressed, it is because their removal is too costly.<sup>99</sup> In other words, markets and institutions work at agency-cost reduction on a going-concern basis. At the same time, agency costs do not reduce to zero and a heroic attempt at agency-cost reduction could be counter-productive.

We argue that post-1980s history acts out Jensen and Meckling's predictions. It has been a dynamic process of cost-reductive adjustment both inside corporations and outside in the market. Managers emerged from the 1980s sensitized to the benefits of shareholder value maximization.<sup>100</sup> The board of directors simultaneously emerged as a more robust monitoring institution.<sup>101</sup> Together, managers and boards used equity-compensation plans to redirect management incentives in the shareholders' direction.<sup>102</sup> Merger volume reached new records, with friendly rather than hostile deals as the means of moving assets to higher valuing users.<sup>103</sup> In addition, the corporate cash-payout pattern underwent a notable shift to yield an unprecedented volume of share repurchases, a central shareholder agenda item.<sup>104</sup>

Discipline, a factor supposedly lacking in the wake of antitakeover regulation, made a remarkable return to the governance front line when the private equity buyout reemerged in the mid-1990s.<sup>105</sup> With this business model, managers looking for enhanced upsides voluntarily put themselves under the control of market intermediaries who monitor costs intensively.<sup>106</sup>

Finally, on the market side of the line, activist hedge funds emerged to show that the shareholder-collective-action problem is not as preclusive as everybody assumed. The activists brought back hostility but on a new platform independent of control transfer.<sup>107</sup> They come forth as value investors and pursue the very financial items that sit at the top of the shareholder proponents' agency-cost agenda—increased leverage, pay-

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99. Jensen & Meckling, *supra* note 43, at 308.

100. Bratton & Wachter, *supra* note 45, at 677–78.

101. Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1022–32 (2010) (surveying the range of pertinent empirical measures of changes in boards of directors).

102. Bratton & Wachter, *supra* note 45, at 678.

103. *Id.* at 678–79.

104. *Id.* at 685–87.

105. William W. Bratton, *Private Equity's Three Lessons for Agency Theory*, 9 EUR. BUS. ORG. L. REV. 509, 513 fig.1 (2008).

106. Bratton & Wachter, *supra* note 45, at 679.

107. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1739–45 (2008) (listing and discussing five motives for hedge fund activism and describing two examples of activist events).

outs of excess cash, premium asset sales, and cost cutting.<sup>108</sup> In contrast to the accelerated share turnover that accompanied the shift to institutional holding, the turnover of the activists' investments was slower: on average, they held shares for a period of two years. They have entered boardrooms in large numbers, all without any change in the legal model. The difference lies in the economics of their shareholding and has to do with institutional incentive alignment.<sup>109</sup>

In sum, where the shareholder proponents depict a governance system that chronically leaves big money on the table, we depict dynamic adaptation focused on removing the money. Patterns of shareholding play a critical role in the process of adaptation. Much of the change can be attributed to the move away from individual holding to institutional holding and its role in ameliorating collective action problems.<sup>110</sup> But our account suggests something more. Critical changes in management policy follow when shares accumulate in three pockets: those of private equity funds, of hedge funds, and of corporate managers themselves. These critical shareholders have two things in common that distinguish them from the market-price setters idealized by shareholder proponents. They are underdiversified (and thus highly incentivized to improve performance at individual firms) and well informed about the business (and thus positioned to offer productive planning and performance inputs). It follows that particular shareholders can be highly relevant so far as concerns value enhancement, even as their socioeconomic status remains irrelevant.

### 3. Summary

Shareholder proponents go to considerable lengths to posit a system of shareholder governance that contains no actual shareholders. Shareholders figure in first as an objective function and then reappear as traders making market prices and anonymous voters in corporate elections. The reason is incentive compatibility. From a microeconomic point of view, the only real-world actor who gives absolutely trustworthy instructions is an actor in the act of own-account buying or selling. But even own-account buyers and sellers can send distorted signals—a result that undercuts the proponents' claim to certitude. Once it is admitted that

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108. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1390–1401 (2007) (listing and describing four ways in which an activist investor with influence can get an immediate return on investment: get the target to sell itself, get the target to sell a major asset, get the target to pay out spare cash, or have the target change its long-term business plans).

109. Bratton & Wachter, *supra* note 45, at 682–84.

110. See Hansmann & Kraakman, *supra* note 64, at 453 (noting that institutional investors are well positioned to articulate shareholder interests).

market signals are less than 100% reliable as measures of fundamental value, managers cannot be subordinated to trading shareholders with respect to business instructions. They must use their own business judgment. Note also that real-world managers engage with real-world shareholders, interacting with shareholder representatives and governance intermediaries as well as with market prices. In consequence, complex and novel agency problems arise.

Finally, we note the existence of three real-world classes of high impact shareholders: private equity managers, hedge fund managers, and corporate managers. With all three classes of shareholders, the impact follows from dissociation with the standard, fully diversified model of the shareholder idealized by the shareholder proponents.

#### IV. TOWARD SOCIAL WELFARE: THE SHAREHOLDER CLASS

Part III described shareholders as governance system functionaries—real people who happen to act out rational expectations models. From a strictly economic point of view, real-world shareholders perform only one additional function: as consumers of goods and services.<sup>111</sup>

This Part steps outside of the economics of wealth maximization to consider shareholders as an interest group in the political economy. We encounter the much-vaunted “shareholder class,” a variant of the middle class that breaks the age-old association between equity ownership and wealth and privilege, and lends a popular coloration to the shareholder proponents’ political agenda.<sup>112</sup> Indeed, the shareholder class poses the long-awaited realization of Adolf Berle’s vision of equitable dispersion of shares among all households in the economy. It would seem to follow that shareholding and social welfare now can travel hand in hand in the big political economy that lies outside the world of wealth-maximization mechanics.

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111. Cf. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1164 (1990) (adding shareholder consumption to share value maximization in the corporate objective function). Here, their wealth presumably imports a positive punch to their economic contribution. But even that point is controversial. See Poterba & Samwick, *supra* note 1, at 296–97 (showing that changes in consumption in the wake of stock market increases follow from the market’s leading indicator function of economic growth for the economy as a whole rather than from gains put in the pockets of particular shareholders).

112. See, e.g., Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 4 (2007) (describing workers with pension savings as “forced capitalists”); Martin Gelter, *The Pension System and the Rise of Shareholder Primacy* (Fordham Legal Studies Research Paper No. 2079607, 2012), available at <http://ssrn.com/abstract=2079607> (ascribing defined contribution pension plans with a causal role in the rise of shareholder primacy).

*A. Diffusing Equities*

The origins of the shareholder class lie in postwar private and public sector pension plans, which made members of the tract-house middle class and the better employed working class beneficiaries of investments in shares. The later proliferation of defined contribution plans and tax-deferred Individual Retirement Accounts (IRAs) turned many pension beneficiaries into actual owners.<sup>113</sup> In addition, the proliferation and easy availability of mutual funds have made equities a feasible place for nonpension savings.<sup>114</sup>

In 2005, the Investment Company Institute and the Securities Industry Association joined hands to report on these developments.<sup>115</sup> They noted that one-half of all U.S. households now directly or indirectly own equities, up from about one-fifth in 1983.<sup>116</sup> They further reported that ninety percent of equity-owning households invest in stock mutual funds, and nearly half of households directly own individual stock.<sup>117</sup> They added that the householders are virtuous shareholders, buying and holding their stock for the long term.<sup>118</sup> The householders “typically” own stock and funds worth \$65,000, representing “more than half” of their total “financial assets.”<sup>119</sup> The householders’ median age is only fifty-one, and only 56% of the group graduated from college.<sup>120</sup>

A caveat should be entered at this point. The same two organizations sponsored another study in 2008, this time tracking equity and bond ownership. The later study reports that from a base point of 32% of householders in 1989, the proportion of equity-owning householders expanded to 53% in the peak year of 2001 and then declined to 45% in 2008.<sup>121</sup> This occurrence might be explained by diminishing participation in defined contribution pension plans. A period of employer-by-employer expansion ended after 2000. And once the saturation point was reached, younger employees felt disinclined to participate, affecting

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113. See *infra* notes 152–62 and accompanying text.

114. See Hansmann & Kraakman, *supra* note 64, at 452.

115. See INV. CO. INST. & SEC. INDUS. ASS’N, EQUITY OWNERSHIP IN AMERICA, 2005 (2005), available at [http://www.ici.org/pdf/rpt\\_05\\_equity\\_owners.pdf](http://www.ici.org/pdf/rpt_05_equity_owners.pdf). The report summarizes results of a survey conducted by the Boston Research Group in January 2005. *Id.* at 39.

116. *Id.* at 1.

117. *Id.*

118. *Id.* at 4.

119. *Id.* More than 40% held stock or stock mutual funds through IRAs. And nearly 90% held some or all of their equities in tax-deferred accounts. *Id.* at 15.

120. *Id.* at 5.

121. INV. CO. INST., SEC. INDUS. ASS’N & FIN. MKTS. ASS’N, EQUITY AND BONDS OWNERSHIP, 2008, at 7 (2008), available at [http://www.ici.org/pdf/rpt\\_08\\_equity\\_owners.pdf](http://www.ici.org/pdf/rpt_08_equity_owners.pdf).



overall ownership numbers. Reversals in the equity markets filled out the explanation.<sup>122</sup>

### B. Political Implications

For Professors Hansmann and Kraakman, the diffusion of equity ownership holds out “a fundamental realignment of interest group structures.”<sup>123</sup> Old oligarchs will fall before the coalescing class of democratized<sup>124</sup> owners:

At the center of this realignment is the emergence of a public shareholder class as a broad and powerful interest group in both corporate and political affairs across jurisdictions. There are two elements to this realignment. The first is the rapid expansion of the ownership of equity securities within broad segments of society, creating a coherent interest group that presents an increasingly strong countervailing force to the organized interests of managers, employees, and the state. The second is the shift in power, within this expanding shareholder class, in favor of the interests of minority and non-controlling shareholders over those of inside or controlling shareholders.<sup>125</sup>

The lines projected by Hansmann and Kraakman have already started to affect the political landscape. The shareholder interest, once seen as distinct from the public interest, now imparts political traction to initiatives in Washington. We can see the shift reflected over time in the terms of new securities legislation.

Let us turn back the clock to 1977, when Congress enacted the Foreign Corrupt Practices Act (FCPA).<sup>126</sup> The FCPA, like the later Sarbanes-Oxley Act (SOX), responded to political demands for management accountability in the wake of scandals. The mid-1970s scandal concerned “questionable foreign payments” from corporations to actors abroad, in connection with the sale of big-ticket American products. Investigators incidentally discovered these payments in the course of the Watergate investigation.<sup>127</sup> The sales, while corrupt, produced bottom-line results

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122. *Id.* at 11.

123. Hansmann & Kraakman, *supra* note 64, at 451–52.

124. For recent descriptions of shareholder empowerment initiatives as “shareholder democracy,” see Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53 (2008); Lisa Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 2 (2008).

125. Hansmann & Kraakman, *supra* note 64, at 452.

126. 15 U.S.C. § 78dd-1 (2006).

127. See Roberta Karmel, *Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 87 (2005). During the Watergate investigations of 1973–1974, the special prosecutor discovered corporate

for the companies' shareholders. The political response had a notable public coloration, casting the managers as irresponsible public actors. In the end, legislators deemed corporate corruption unacceptable, even corruption abroad in pursuit of shareholder value at home, and new ethical standards were imposed in law.<sup>128</sup> The shareholders' economic interests imposed no constraint on the lawmakers' pursuit of public welfare.

The more recent enactment of SOX admits of a similar reading. Although nominally investor protective, it accorded shareholders no new powers. Instead, it imposed good-governance constraints on businesses with the goal of sharpening compliance incentives and keeping corporate risk-taking within socially acceptable limits.<sup>129</sup> Viewed this way, SOX is no more about shareholder value maximization than was the FCPA. Like the FCPA, it imposes public accountability on large corporations. The goal is not shareholder value enhancement but public legitimacy for big business.<sup>130</sup>

But unlike the FCPA, SOX was prompted by scandals without immediate ties to elected officials, scandals tied to spectacular losses at a number of large enterprises. As noted above, shareholding had become much more diffuse after 1977, and shareholder losses figured into the political motivation. Politicians, moreover, began to cater to the "investor class"<sup>131</sup> and promoted an "ownership society"<sup>132</sup> in which individually vested pension savings played an important role. So when Congress enacted SOX, even though retail investors, viewed as an interest group,

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political slush funds that evaded normal accounting controls. See GEORGE C. GREANIAS & DUANE WINDSOR, *THE FOREIGN CORRUPT PRACTICES ACT: ANATOMY OF A STATUTE* 63 (1982). The SEC announced a voluntary disclosure program, see Daniel Pines, *Amending the Foreign Corrupt Practices Act to Include a Private Right of Action*, 82 CALIF. L. REV. 185, 187-88 (1994), and there resulted admissions by over 450 companies. *Id.* at 187-88. It was the Watergate era, and the public demanded a cleanup of corporate corruption. DONALD R. CRUVER, *COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT* 5 (2d ed. 1999).

128. See Andrei Shleifer, *Does Competition Destroy Ethical Behavior?*, 94 AM. ECON. REV. 414, 418 (2004) (noting that as societies grow rich they prove more willing to pay for ethical behavior through enforcement).

129. Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1820, 1828-29 (2007).

130. *Id.* at 1820.

131. In 2004, one third of American voters described themselves as "investors," and national politicians now cater to the so-called "investor class." See Richard S. Dunham & Ann Therese Palmer, *Just Who's in the 'Investor Class,'* BUS. WEEK, Sept. 5, 2004, at 42-43, available at <http://www.businessweek.com/stories/2004-09-05/just-whos-in-the-investor-class>.

132. Office of the Press Sec'y, The White House, *Fact Sheet: America's Ownership Society: Expanding Opportunities*, NAT'L ARCHIVES (Aug. 9, 2004), available at <http://georgewbush-whitehouse.archives.gov/news/releases/2004/08/20040809-9.html>.

continued to have little influence,<sup>133</sup> the shareholder qua shareholder edged closer to the median voter and loomed large politically. And shareholder empowerment, missing in SOX, followed in the next round: the Dodd-Frank Act of 2010 enabled corporations to place shareholder board nominees in management proxy statements, and also accorded the shareholders “say on pay,” among other things.<sup>134</sup>

This shareholder politics has a progressive overlay,<sup>135</sup> but on what basis? In the shareholder economic agenda, are interests of other corporate constituents actually regarded as relevant to the wealth-maximization calculus? The answer is no. If you look at the agency-cost reduction play-book, whether in the hands of a governance intermediary or of a hedge fund activist, you find three items: premium sales of companies or divisions of companies in the market for going-concern assets; payouts of cash as dividends or share repurchases; and cuts in operating costs.<sup>136</sup> None of the three items addresses any benefits for corporate constituents like labor and dependent communities. Shareholders, as residual-interest holders, benefit when contracts with other constituents are rewritten or terminated so as to lower the cost of production inputs.

Even so, union pension funds actively press the case for shareholder governance and shareholder value.<sup>137</sup> We confront an apparent puzzle: why should trade union actors or other political progressives support a shareholder political agenda? To the extent a puzzle exists, its solution lies in defusing the tension between labor and equity. The diffusion of equity ownership goes some distance toward that goal. Further distance results when we remember that the 1980s were a long time ago. The plants closed for the shareholders’ benefit in those days are not reopening. Nor is anyone extending new rights to defend labor against corporate restructuring. With union membership down to 6.6% of private sector employment,<sup>138</sup> private sector managers and union leaders do not even come into contact very often. Indeed, organized labor, faced with declin-

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133. See Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the US Experience* 10–11 (Georgetown Pub. Law Research Paper No. 624582, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=624582](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=624582).

134. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951, 953–55, 971, 124 Stat. 1376, 1899–1905, 1915 (2010).

135. See John W. Cioffi & Martin Höpner, *The Political Paradox of Finance Capitalism: Interests, Preferences, and Center-Left Party Politics in Corporate Governance Reform*, 34 POL. & SOC’Y 463, 480–84 (2006) (noting that Democrats rather than Republicans tend to back proshareholder reforms).

136. See Bratton, *supra* note 108.

137. See Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1019 (1998).

138. Economic News Release, Bureau of Labor Statistics, *Union Members Summary* (Jan. 23, 2013), available at <http://www.bls.gov/news.release/union2.nr0.htm>.

ing membership, finds pensioners looming larger relative to active employees among its own constituents.<sup>139</sup> Labor and shareholders also have a shared interest in reducing management compensation. For the shareholders, lower managerial pay means a higher residual claim, assuming that managerial behavior is unaffected. For labor, greater pay equalization across skill groups, including the executive officers, is a core goal. Overall, as labor adjusts its expectations, the conflict with the interests of shareholders becomes less clear-cut.

That said, the politics surrounding the shareholder class follow from narrow, carefully etched characterizations of the interests at stake. The managers are bad, entrenched oligarchs. A legitimacy problem results when managers make decisions with consequences for social welfare. Gilson and Kraakman describe the problem this way: "Do we want to encourage an institution that is disproportionately white, male and conservative to make social policy?"<sup>140</sup> Thus, shareholder empowerment democratizes and legitimizes. Fold in excessive pay accusations, and the managers are not only oligarchs, but plutocrats.<sup>141</sup> The shareholders are the oppressed populace. Empowering them reduces the burden of oppression and is intrinsically good.

Part V looks more closely at these shareholder victims. The socioeconomic status of the real-world beneficiaries of shareholder value maximization becomes relevant at this point in the discussion.

## V. WHO THE SHAREHOLDERS ARE

We have seen that shareholders provide the corporation an objective function without regard to their socioeconomic status. We also have seen that shareholder proponents aspire to a similar structural disengagement when posing shareholder market-price inputs as a real-world management focal point. The above discussion has showed that discordant inputs from real-world shareholders cloud that picture, but that the socioeconomic status of real-world shareholders remains beside the point.

Socioeconomic status finally comes to the fore with the shareholder class. We are told that the world has changed. Whereas only 20% of households held equity investments forty years ago, now almost half of households hold equities.<sup>142</sup> It supposedly follows that shareholders are

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139. See Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Wealth Proposals*, 73 WASH. L. REV. 47, 49 (1998).

140. See Gilson & Kraakman, *supra* note 56, at 604 n.21.

141. See *id.* at 604 (describing Blair and Stout's managers as "mediating hierarchs" and "mediating plutocrats").

142. See *supra* note 116 and accompanying text.

just folks whose interests as a class should be advanced in an enlightened political economy. In this Part, we test this proposition<sup>143</sup> with data from the Federal Reserve Board's triennial Surveys of Consumer Finances (SCFs). We then run a cross-check with data on 2009 personal income tax returns made available by the Internal Revenue Service.<sup>144</sup>

### A. The Modal Shareholder

#### 1. Rich, Old, and White

Figure 1: Households with Stock Holdings, 1989–2007/2010<sup>145</sup>



The SCF reports on the percentage of households owning stock. The top line in Figure 1 shows the results from the SCFs conducted from 1989 to 2010. The SCF numbers confirm the report of the Investment Company Institute and the Securities Industry Association. Stockholding households increased from just over 30% in 1989 to over 53% in 2001 and dropped back to just under 50% by 2010 (stockholding meaning direct holding and holdings in and through IRAs, pension accounts, and

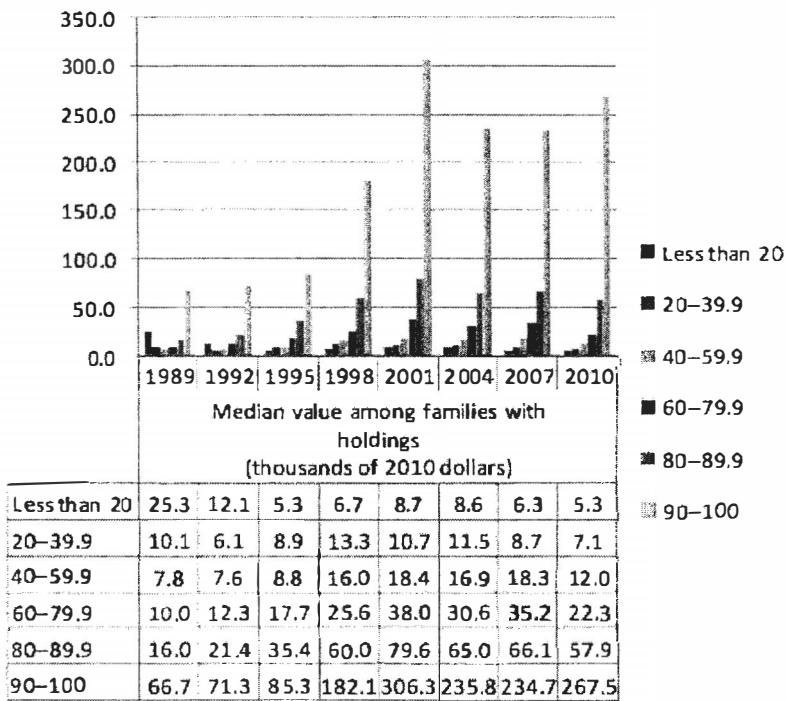
143. We make no claim to be the first to do this. For precedent discussions of the socioeconomic profile of shareholders referencing earlier Federal Reserve surveys, see Poterba & Samwick, *supra* note 1.

144. The data are available at the Internal Revenue Service website, *SOI Tax Stats - Individual Income Tax Return (Form 1040) Statistics*, INTERNAL REVENUE SERV., <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Return-Form-1040-Statistics> (last visited Nov. 29, 2012).

145. See Jesse Bricker et al., Bd. of Governors of the Fed. Reserve Sys., *Changes in U.S. Family Finances From 2007 to 2010: Evidence From the Survey of Consumer Finances*, FED. RES. BULL., June 2012, at 41 tbl.7, available at <http://www.federalreserve.gov/pubs/bulletin/2012/PDF/scf12.pdf>; Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle Class Squeeze—An Update to 2007*, at 56 tbl.14b (Levy Econ. Inst., Working Paper No. 589, 2010), available at <http://www.levyinstitute.org/publications/?docid=1235>. For a PDF with a color image for Figure 1, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/>.

trust accounts, along with mutual fund holdings). To get a more granular picture of this data, we refer to Professor Edward N. Wolff’s<sup>146</sup> analysis of the data in the 2007 SCF. Professor Wolff breaks the households down in accordance with amounts invested. If we ask for a stake of \$10,000 or more, the number of equity-holding households drops to 35% at the 2001 peak and 25% in 2007; if we ask for \$25,000, the percentages drop to 27% and 22% of households. In other words, roughly half of the equity-holding households in 2007 had portfolios of less than \$10,000. The ICI/SIA report of a “typical” household equity holding of \$65,000 becomes a questionable characterization based on a median figure.

Figure 2: Mean Stock Holdings by Income Category 1989–2010<sup>147</sup>

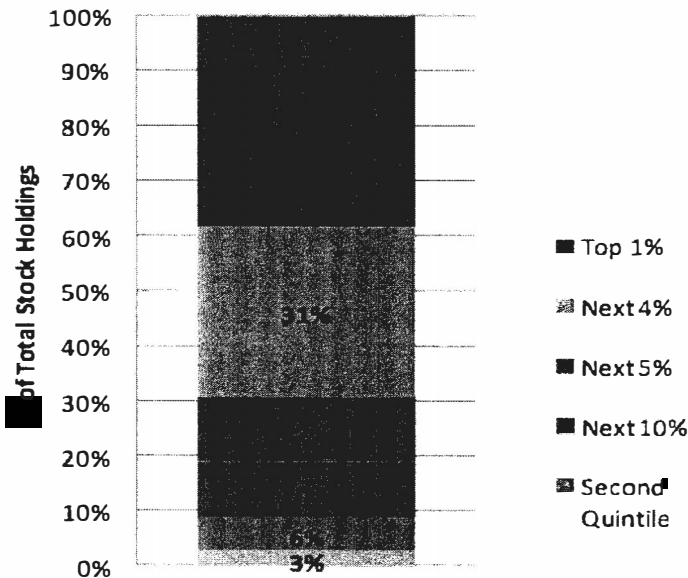


Who then owns, directly or beneficially, the shares? Figure 2 draws on the SCF reports to set out median stock-portfolio values in 2010 dollars, breaking households into wealth categories by net income, and

146. Wolff, *supra* note 145.  
147. Bricker et al., *supra* note 145, at 41 tbl. 7. For a PDF with a color image for Figure 2, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/> (last visited Feb. 22, 2013).

showing all stock holdings, direct and indirect through mutual funds, pension accounts, and other managed assets. In 2010, the median portfolio of the top 10% by income was \$267,500, where the 80% to 90% group by income held stock worth \$57,900, the 60% to 80% group held stock worth \$22,300, and the 40% to 60% group held stock worth \$12,000. There is evidence that wealth imbalances between the groups have shifted over time, but there are no consistent leveling trends. The ratio between the median portfolios of the top ten percent and the next ten percent at the start of the period in 1989 was 4.2 to 1. It narrowed to 2.4 to 1 by 1995, then began widening, ending 2010 at 4.6 to 1. The spread between the top ten percent and the second quintile displayed a similar pattern, beginning at 6.7 to 1 in 1989 and ending at 12 to 1 in 2010. The SCF also breaks out direct holdings of stock by mean and by net worth classification as well as by income. The spreads over time yielded by these data are similar.<sup>148</sup>

Figure 3: Concentration of Stock Holdings by Wealth Class, 2007<sup>149</sup>



148. The survey reports also break out direct holdings of stock by medians and means, in accord with income classification and wealth classification. These figures show similar spreads. See *id.* at 25 tbl.6.

149. See Wolff, *supra* note 145, at 58 tbl.15a. The data reflect direct and indirect holdings. For a PDF with a color image for Figure 3, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/> (last visited Feb. 22, 2013).

Thus, to construct a likeness of the modal shareholder is to select a household in the top-ten-percent category, measured by income or by wealth. We can get a better illustration of the breakdown within the top ten percent by net worth by consulting Professor Wolff's report of the 2007 SCF data. Figure 3 depicts his classification, which looks at stock-portfolio size household by household rather than clumping them into means and medians by wealth or income class. He shows that in 2007 the top ten percent by wealth class owned 81% of the stock, with the top one percent owning 38% (or 47% of the stock held by the top ten percent). The bottom eighty percent, in contrast, owned only 9% of the stock. Thus, the modal shareholder is a member of the elite one percent.

Figure 4: Stock Ownership of the Top 10%, 1989–2007<sup>150</sup>

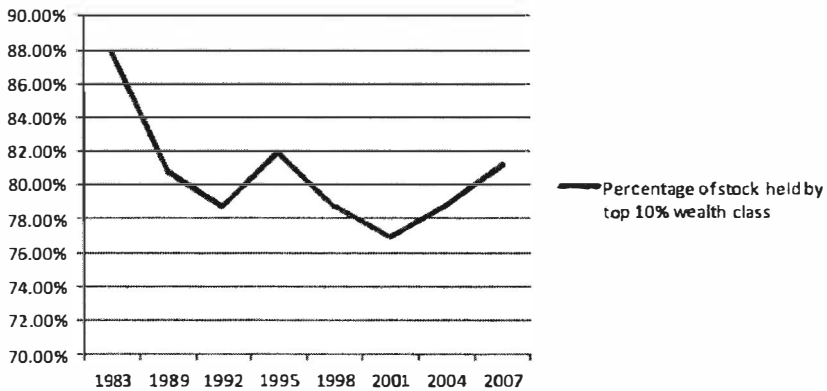


Figure 4 sets out Professor Wolff's report of the share holdings of the top-ten-percent wealth class across time. We see that some flattening occurred around the time the shareholder class made its appearance in the political economy. In 1983, the top ten percent owned 89% of the stock, a proportion that dropped to 81% by 1989,<sup>151</sup> the same 81% that obtained in 2007. Between those years, percentage-ownership figures fluctuated up and down in a band with equality waxing in 2001, when the top ten percent owned an historic low of only 77% of the stock. Interestingly, even as the percentage of householders owning stock marched upward as defined contribution plans proliferated during the 1990s, the change did nothing to erode the percentage share of the top ten percent of households.

150. *Id.* at 51 tbl.9.

151. Movement from defined benefit plans to defined contribution plans accelerated during the 1980s. See Gelter, *supra* note 112, at 19–20.



Figure 5: Mean Stock Holdings by Age Category, 2010<sup>152</sup>

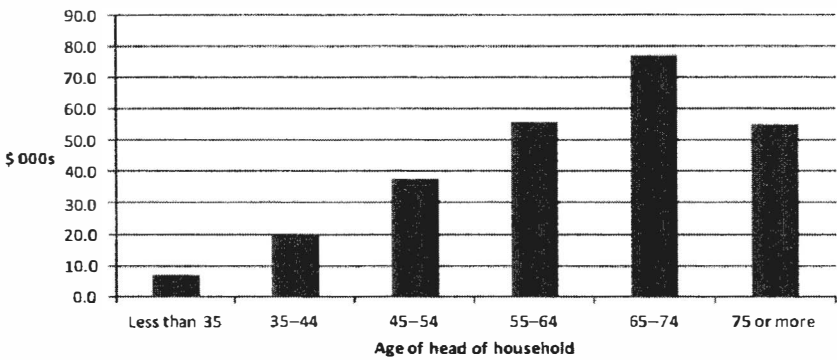


Figure 5 draws on the 2010 SCF to divide direct and indirect ownership of stock by six age-group categories. The message is simple—most of the stock sits in the portfolios of which the head of the household is 65 years of age or older. The result is unsurprising: for people who are wealthy enough to accumulate at all, the accumulation grows as the people get older. At the same time, the modal model of the equity holder picks up a factor—the “typical” shareholder is not only rich, but old.

Having gotten that far, we could add “white” to the modal description by implication. But we can back up the assertion by reference to the SCF. The SCF codes respondents into five groups by race: White non-Hispanic, non-Hispanic African American, Hispanic, Asian, and Other—the last category including those who refuse to identify themselves in the first four categories.<sup>153</sup> The SCF reports the results in two categories, White non-Hispanic, and Nonwhite or Hispanic, with the latter category picking up Asian respondents.

152. Bricker et al., *supra* note 145, at 41 tbl.7.

153. *Bulletin Macro*, FED. RES, <http://www.federalreserve.gov/econresdata/scf7/files/bulletin.macro.txt> (last visited Nov. 29, 2012).

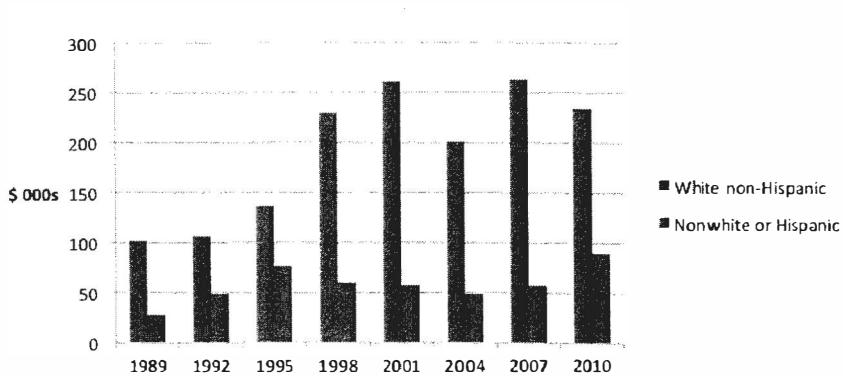
Figure 6: Direct Stock Holdings by Race Category, 1989–2010<sup>154</sup>

Figure 6 reports results for mean portfolios of directly held stocks from the SCFs from 1989 through 2010. The portfolios of White, non-Hispanic respondents are consistently larger, but the spreads between the two vary widely. The narrowest spread came with the 1995 SCF's portfolios at 1.8 to 1; the widest was in 2007 at 4.6. The 2010 spread was 2.6.

Public disclosures of SCF data omit Asian responses while including responses from the other categories.<sup>155</sup> This permits non-Hispanic Whites to be compared to African Americans and Hispanics with respect to all response categories.

154. Bricker et al., *supra* note 145, at 25 tbl.6. For a PDF with a color image for Figure 6, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/> (last visited Feb. 22, 2013).

155. *Bulletin Macro*, *supra* note 153. The inclusion of Asians as a minority presumably would change the proportions without changing the overall result. For evidence that median Asian family income exceeds that of other American households taken as a whole (\$66,000 to \$49,800), see *The Rise of Asian Americans*, PEW RESEARCH SOCIAL & DEMOGRAPHIC TRENDS (June 19, 2012), available at <http://www.pewsocialtrends.org/2012/06/19/the-rise-of-asian-americans>.

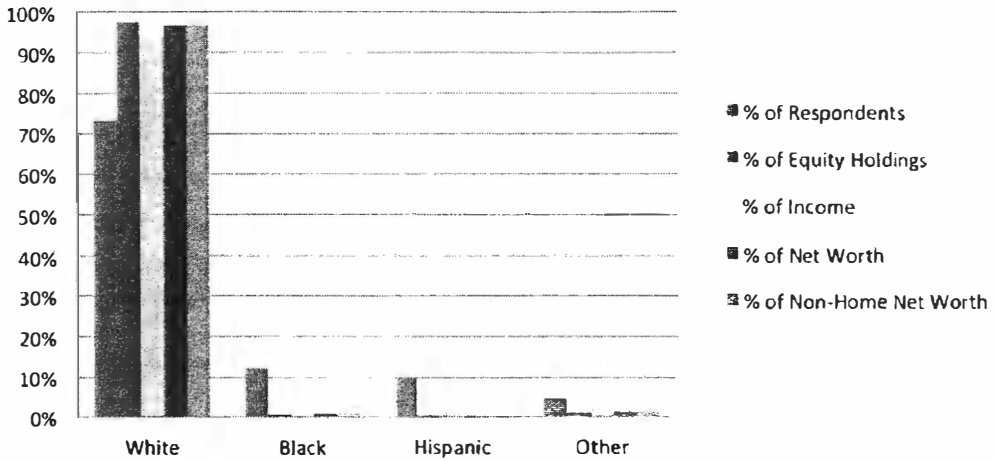
Figure 7: Income and Wealth by Race Category, 2010<sup>156</sup>

Figure 7 juxtaposes these race categories with respect to income, net worth, non-home net worth, and direct and indirect stock holdings. Income and wealth disparities are more notable in this presentation, and they stand at their widest with respect to stock holdings.

To sum up, in these data the modal shareholder is rich, old, and white. As noted, the SCF provides no information on Asians. Nor does it address gender, for “household” is the unit of measurement.

## 2. Internal Revenue Service Cross-Check and Defined Benefit Plans

We have seen that the SCF depicts asset holdings. Its pension category picks up the cash surrender value of plans such as IRAs, Keoghs, and 401(k)s,<sup>157</sup> but does not pick up value stemming from defined benefit plans. This makes sense, for the beneficiaries of these plans have no ownership interest in plan assets. They have a promise to pay and back up insurance for distress situations from the government’s Pension Benefit Guaranty Corporation.<sup>158</sup> The upside residual on plan assets belongs to

156. Source: Federal Reserve. *2010 Survey of Consumer Finances*, FED. RES., [http://www.federalreserve.gov/econresdata/scf/scf\\_2010survey.htm](http://www.federalreserve.gov/econresdata/scf/scf_2010survey.htm) (Excel Extract Data) (last visited Nov. 29, 2012). For a PDF with a color image for Figure 7, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/> (last visited Feb. 22, 2013).

157. Wolff, *supra* note 145, at 6.

158. 29 U.S.C. § 1302. The PBGC in turn has certain rights in bankruptcy. There is a statutory lien on unfunded liabilities over \$1,000,000. I.R.C. § 412(n) (2008).

the residual-interest holders in the promisor, whether a corporation, a municipality, or a state.<sup>159</sup>

To the extent the defined benefit plans are funded, they hold a stock of equity investments available for plan beneficiaries, and the plans make present distributions to retired beneficiaries.<sup>160</sup> To get a glimpse of the distribution pattern, we accessed personal income tax return data made available by the Internal Revenue Service.

Figure 8: Top 1.5% Earners as a % of Total Income Reported 2009<sup>161</sup>

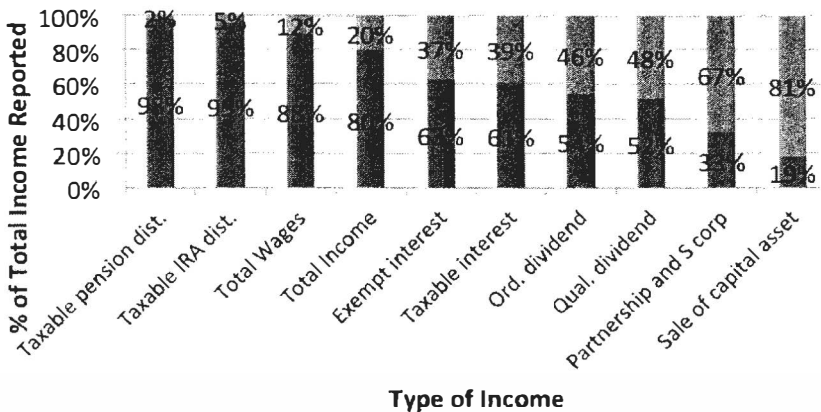


Figure 8 draws from 2009 1040 tax return data to depict a series of income categories: pension distributions, IRA distributions, total wages, total income, tax-exempt interest, taxable interest, ordinary dividends, qualified dividends, income from partnerships and S corporations, and net proceeds from sales of capital assets (long- and short-term). The taxable pension-distribution category picks up payments from both defined contribution and defined benefit plans but does not include taxable social security payments. The bar for each income source is divided between the share of the top 1.5 percent of taxpayers in regards to reported income, a category with an income floor of \$500,000.

159. See Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1539–40 (1997).

160. In fact, defined benefit plan portfolios are weighted slightly less with equities than are defined contribution plan portfolios. See Gelter, *supra* note 112, at 15.

161. For a PDF with a color image for Figure 8, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/> (last visited Feb. 22, 2013).

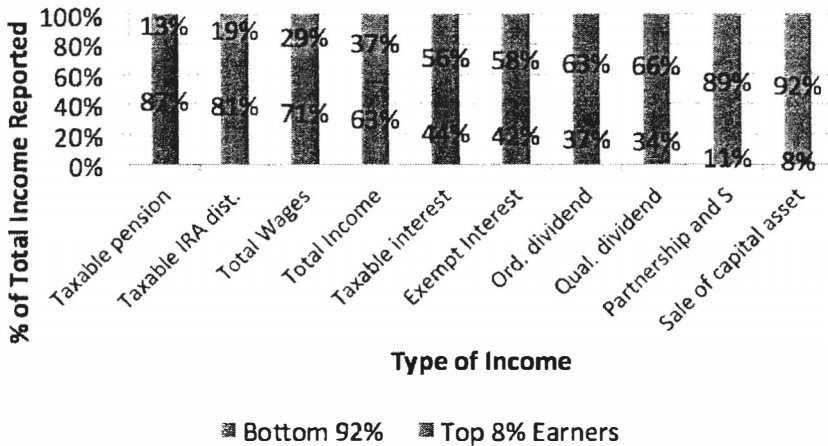
Figure 9: Top 8% Earners as a % of Total Income Reported, 2009<sup>162</sup>

Figure 9 takes the same data and divides the bars between the share of the top eight percent of taxpayers with respect to reported income, a category with an income floor of \$200,000.

In regards to the two bars on the right in the figures—partnership and S corporation income and income from sales of capital assets—the IRS figures roughly confirm the distributional pattern drawn from the SCF, with the top 1.5 percent taking the lion's share. The dividend figures stand apart more widely, with the top eight percent in taxable income taking 63% and 66% of the dividends, as compared with the top ten percent's ownership of 81% of the stock in the SCF results. The divergence continues with the total income figures—the IRS top eight percent takes 37% of the total income, as compared with the SCF top ten percent's 47%. These divergences are to be expected. Top-bracket taxpayers have the incentive and means to engage in tax planning, shifting assets and returns from assets out of tax-reporting categories.

In any event, the figures on pension and IRA distributions present a marked contrast, with the top eight percent taking only 13% of the former and 19% of the latter, significantly less than their 29% share of total wages. Here, we at last get a hint of deeply distributed stock ownership. To get a better sense of the depth, we can break the pension and IRA data at \$100,000 total income to find that 64% of the pension income goes above the \$100,000 line along with 80% of IRA income. Most of these retirees, it seems, are fairly well off.

162. For a PDF with a color image for Figure 9, see *Archive*, SEATTLE U. L. REV., <http://seattleuniversitylawreview.com/archive/> (last visited Feb. 22, 2013).

### 3. Summary

Overall, we think the modal picture of the rich, old, and white shareholder emerges intact.

While shareholding has moved down the socioeconomic scale over the last thirty years, the change holds out no sharp break with previous distributive patterns. Interestingly, the deepest downward penetration comes with defined benefit pension holdings, the form least consistent with an "ownership" designation.

#### *B. People v. Oligarchs?*

This section explains why proponents of the shareholder class offer household ownership proportions of equities on a yes-or-no basis and then stop. Shareholding has indeed found its way deeper into the population during the past three decades, even as it is a surprise to learn that the downward shift from the top ten percent took place before 1989, and since then there has been no sustained downward movement. It now appears that even as roughly half of American households own some stock, most of those households do not own very much. The modal shareholder is in the top one percent, and the top-ten-percent wealth class owns 81% of the stock. To reference a shareholder class, then, is to reference an upper-middle-class to upper-class group. Berle's vision of shares spread equitably among the nation's households is not even close to fulfillment. At the same time, his point about the importance of the socioeconomic status of shareholders remains robust. Why otherwise would the proponents ever have bothered to posit a shareholder class?

It remains fair to say that when shareholder proponents attack managers, they speak for a "dispersed" interest and take on hierarchic superiors. But as the description of the shareholder gets thicker, the confrontation described loses its progressive cast. These conflicts amount more to family quarrels among actors in the top brackets than democratizing struggles between a leadership elite and oppressed citizens. A battle between managers representing the "haves" and shareholders representing the "have-nots" simply does not work as a representative picture.

Even the characterization of the many rising up against a few should be taken with a grain of salt. Intermediaries from the mutual fund and pension fund industries, along with informational intermediaries like Institutional Shareholder Services, do much of the work for the shareholders. Look through the beneficial owners to the actors exercising the power on the shareholder side, and corporate politics can be depicted as a

field of conflict between two rich, self-interested groups.<sup>163</sup> Interestingly, both groups are agents of the same shareholder principals. Given the steady shortening of CEO tenure on the one hand and concentration among informational intermediaries on the other, it is by no means clear that the managers are the more entrenched.

The questions keep coming. What are the social welfare implications of a corporate politics in which one small set of agents seeks empowerment at the expense of another? Does management disempowerment, by itself, somehow enhance social welfare? There appear to be no redistributive benefits. Nor is there any meaningful enhancement of corporate political legitimacy. The shareholder class does vote and favorable votes can legitimize exercises of power that impact social welfare. But shareholder voting does not sustain an analogy to voting in a democratic polity. An analogy exists only with respect to a polity in which the voting power is allocated in line with the *ex ante* allocation of wealth.

It follows that benefits stemming from shareholder inputs can come only in the form of efficiency enhancement. Unfortunately, as we saw in Part III, these benefits are at best elusive and at worst, value negatives. The “shareholder class,” whatever its socioeconomic composition, is not sufficiently well informed to make a positive productivity contribution. But some shareholders—private equity firms, hedge funds, and corporate managers—do make positive contributions. The contributions stem not from the fact that they make up a shareholder “class” or “classes.” Instead, the contributions follow from the fact that these shareholders are highly incentivized to increase the value of the companies in which they invest, and critically, are well informed about the companies’ businesses, markets, and prospects.

## VI. CONCLUSION

Shareholder value enhancement certainly impacts economic efficiency. But because shareholders are rich, old, and white, any connection

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163. Berle saw the possibility that these actors might enter the scene more than sixty years ago. He noticed that more and more stock had been accumulating in pension funds, insurance-company vaults, and mutual funds. These institutions, together with a handful of large New York banks operating as trust fund custodians, constituted a new nucleus of power. He saw that this small oligarchy potentially could exercise power over management as it accumulated and deployed risk capital. BERLE, *POWER*, *supra* note 11, at 49–51. However, so long as the investment intermediaries remained passive, they exacerbated the separation of ownership and control, extending the distance between managers and the individuals who were the ultimate beneficial owners. *Id.* at 55. It would be a different story if the institutions woke up and exerted power over management tenure, ending management’s self-perpetuating oligarchy. But the separation of ownership and control would not thereby be solved: one set of oligarchs, the managers, would be replaced at the top by another, the self-perpetuating institutional managers. *Id.* at 59–60.

between corporate politics and social welfare enhancement is at best tenuous and at worse regressive. We are left with a corporate politics populated by two opposing elite groups, each group in turn populated with representatives of the same shareholder principals. Perhaps the conflicts will yield over time to accommodation, and we will see a system that advances the interests of both. If we can resolve differences between managers and shareholders, society can be better off. But making broader claims of welfare enhancement for the rest of the body politic is simply a mistake.